

Regulatory Reform and the Role of Competition Policy

by

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Introduction

G.J.Stigler, who is a representative economist of the Chicago School, once compared the pleasures of Capitalism with the pains of Capitalism, and concluded that the government should promote deregulation and call for a return to an open, competitive economy. In this paper, he argued about the regulated sector as the biggest source of all growth industries and concluded that all consumers had become losers under a “myopic Robin Hood” (=modern state), which has intervened economy without explicit rational reasons.

Since the victory of the Chicago School in the 1980s, the leading countries such as the US and the UK have pursued Deregulation and Privatization policies boldly and the

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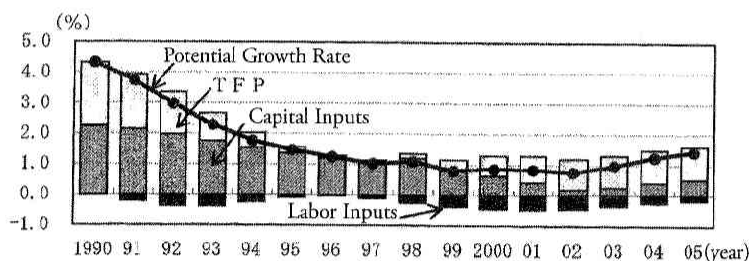
other advanced countries followed them with similar policies. But, except for common-law countries, other advanced countries have different views of public choice based on social democracy and traditional public governances characterized by their own culture. Therefore, the “road to freedom” has not proceeded straightforward. This tide has been modified and integrated into the world-wide “Regulatory Reform Initiatives” mainly advocated by the OECD. We are now on the way to such a regulatory reform.

1. Factors of Recent Economic Recovery in Japan

A. Economic Recovery

Japan has finally emerged from an extended period of economic stagnation in the lost decade. The GDP growth rate in FY2005 was 3.2% in real term, and 1.8% in nominal term. Corporate profits and employment situation have been improving; the unemployment rate fell to 4.0% in May 2006, the lowest level in eight years. The fiscal primary balance is expected to improve from -4.4% in FY2001 to -2.4% in FY2006. These figures indicate that renewed economic expansion is getting back on track of stable economic growth (Figure 1-1).

Figure 1-1 Progress of Potential Growth Rate



source: Cabinet office (2005), The Economic and Finance white Paper

B. Current Strategies to Secure Stable Economic Growth

Japan has announced five initiatives to sustain robust economic growth over the medium term. That is,

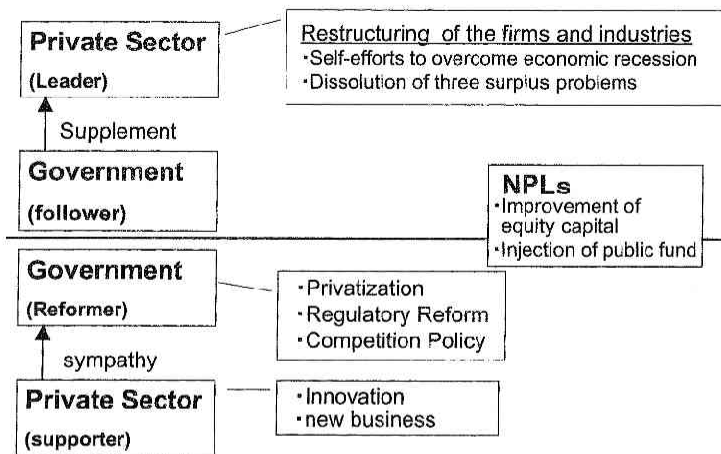
- To implement a new monetary policy framework. The Bank of Japan attempts to raise interest rates cautiously to overcome deflation pressure, while securing the yen rate (=value of yen) in the world economy.

- To achieve fiscal consolidation. Government attempts to maintain confidence in the budgetary debt problem by aiming to achieve a primary budget surplus by the early 2010s.
- To promote structural reform while reducing income inequality and relative poverty. To remedy the distortions resulting from firms' restructuring, the government tries to dissolve the increased dualism in the labor market by reducing the number of non-regular workers.
- To upgrade national innovation. Japan aims at raising productivity growth directly by increasing investment in innovation, strengthening legal structure of intellectual property rights.
- To strengthen the integration of Japan in the world economy. In this respect, Japan now targets doubling the FDI as a share of GDP by 2010 and addresses to open up the market of M&A to foreign investors by allowing them to use their own shares to finance mergers.

C. Factors of Economic Recovery

Why and how could Japan overcome the negative legacy of collapse in the 1990s and finally restore the economic growth? Two types of structural reform have been effective to restore the economic upturn. One type of reform is the private sector-led economic recovery, where the government complemented the private initiatives with a series of regulatory reform. The other type of reform is the government-led structure reform including a series of privatizations and regulatory reforms, where the private sector sought business opportunities and developed new businesses (Figure 1-2).

Figure 1-2 Factors of Economic Recovery



Basically, the private sector has a powerful driving force of reform. That is, the private sector has exercised the initiatives in improving the economic efficiency through dissolving the so-called three surplus issues (=surplus capacity, over-employment and excessive debt) and restructuring boldly their finances, businesses or employments to enhance their corporate performances.

Especially, in the financial sector, many efforts have been devoted to disposing of non-performing loans (NPLs). The major banks' bad loan problems have been alleviated during the concentrated consolidation period (from FY2001 to FY2004) under the strong government support (=providing public funds). During this period of financial reform, the existing six big bank groups were consolidated into three big groups, which enabled the financial system in Japan to get back reliability of the financial market.

The other type is the government-led structural reform. Prime Minister Koizumi's leadership toward structural reform changed the atmosphere and circumstance of economy. His catchphrase of "shift from public to private sector" or "shift from central to local government" captured the public minds. Supported by high popularity, he promoted the following structural reform package.

- To reform policy-based finance and review independent administrative institution.
- To increase the number of municipalities without local allocation tax.
- To reform the government assets and debts.
- To introduce Market Testing based on the "Law on Public Service Reform".
- To promote E-government for the purpose of enhancing administrative efficiency

through more ICT utilization.

Among them, promoting regulatory reforms is one of the key factors to substantially contribute to economic recovery. In addition to the elimination of the demand-supply adjustment regulations, which controlled almost all public utilities, more than 1500 items were deregulated during five years up to March 2006. Regulatory reforms were extended to areas of social regulations such as medical care, social welfare, education in this period. 847 “Special Zones for Structural Reform”, in which related regulations are to be exemplified in accordance with zones’ specific characteristics or circumstances, were approved.

2. Regulatory Reform in Japan : Process and Results

A. Process of Regulatory Reform in Japan

In the 1990’s, the emphasis in Japan had been focused on deregulation. The goal of such regulatory policies had been to move the economy from a model of state-led growth to a model of market-led growth characterized by a more efficient and flexible economy. However, this transition had required the government as a whole to undertake comprehensive action-plan, while enhancing its capacity toward regulatory reform. Then, receiving OECD’s recommendations, Japan adopted a whole-of-government approach toward better regulations and implemented a series of Three Year Program for Regulatory Reform in the 2000s.

The Koizumi administration decided on many regulatory reforms in 2004. The highlights included; (a) establishment of inter-ministerial committee to serve as a headquarters for regulatory reform, (b) strengthening the power of the Council on Regulatory Reform (CRR), (c) introduction of Regulatory Impact Analysis (RIA), (d) promotion of the Special Zones Programme (SZP), and (e) selection of 17 priority reform areas. Among them, the Special Zones Programme, which was initiated by the Council on Regulatory Reform, is a unique approach.

The SZP has a local area -based approach to deregulation. Due to the SZP law approved in 2002, many regulations have been alleviated or lifted in geographically limited areas as a testing ground. At that time, nation-wide reform was too difficult to be implemented at a burst, because most ministries and interest groups opposed or resisted such an initiative based on their interests. Therefore, the government adopted an ingenious programme which combined decentralization policy with regulatory reform. The SZP has the potential to be effective in removing unnecessary regulations and in re-

vitalizing local economies. By 2005, 547 regulatory reform proposals had been accepted. Of them, 206 were tried in 709 special zones while the remaining 341 proposals were implemented nationwide from the beginning (Table 2-1). However, it is still too early to judge the outcome of this initiative, which faces a number of obstacles. Firstly, the special interest groups may stall the implementation of key reforms such as management of hospitals by corporations. Secondly, there is a risk that these important reforms will not develop on a nation-wide basis by the resistance of the concerned ministries. Thirdly, there is also a possibility that the special zone initiative will not lead to local economic development as it deregulates only a narrow limited area. In order to secure this initiative as an important tool of regulatory reform the allowed items in the special zones should be generalized nation-wide quickly, avoiding unduly long periods of its evaluation.

Table 2-1 Reform Proposals Accepted Nation-wide under the Special Zone Initiative

Ministry or agency	Accepted in special zones	Accepted nation-wide	Total
National Public Safety Commission	4	3	7
National Personnel Authority	3	0	3
Financial Services Agency	2	11	13
Ministry of Internal Affairs and Communications	12	40	52
Ministry of Justice	15	20	35
Ministry of Foreign Affairs	2	9	11
Ministry of Finance	7	18	25
Ministry of Education, Culture, Sports, Science and Technology	35	33	68
Ministry of Health, Labour and Welfare	35	86	121
Ministry of Agriculture, Forestry and Fisheries	10	13	23
Ministry of Economy, Trade and Industry	52	46	98
Ministry of Land, Infrastructure and Transport	19	53	72
Ministry of the Environment	9	8	17
Cabinet Office	1	1	2
Total	206	341	547

Source: Office for the Promotion of Special Zones for Structural Reform.

The review of the existing regulations and administration simplification measures is underway through e-government policy which aims to make all existing administrative formalities and procedures available through Internet. However, most of them still remain at the level of one-sided services. With regard to reviewing existing regulations, although elimination of demand and supply balancing provisions associated with regulations of public utilities and conversion from ex ante permits and licenses system to ex post control system have been major objectives of regulatory review, a survey shows that the number of ex ante permits and licenses has not been significantly reduced.

Recently, the government has promoted the “Market Testing” based on the law of Public Service Act and introduced the (Regulatory Impact Analysis) RIA system in 2004. The former is expected to benefit consumers, promote fiscal consolidation and provide

new opportunities to the business sector. The latter is expected to enhance the quality of regulation and contribute to reduce regulatory or administrative burden in terms of compliance costs. However, the progress of these schemes, which were implemented as pilot projects or experimental trials, is too slow to be fully implemented. At the central level, only a few government services have not been exposed to competitive tendering among private businesses. Although the number of RIAs increased to 79 in 2005, the number of the assessments including quantitative analysis was only 4 (Table 2-2).

Table 2-2 State of Enforcement about the OECD's 1999 Recommendations

1.Regulatory policy

- Supply and demand adjustment regulations eliminated in most sectors
- The activity of comprehensive Three-Year Programs for Regulatory Reform. Still remain based on an item by item approach.
- Policy Evaluation System (PEC) introduced in 2002, and Regulatory Impact Analysis introduced in 2004. But, we cannot still find the outstanding results.

2.Regulatory institutions

- The council of Regulatory Reform within the cabinet office negotiates directly with the relevant ministries. Recently, the role of CRR seems to be retreating.
- Policy and regulatory functions remains under the control of the relevant line ministries, although recommended to separate their functions by the OECD.

3.Regulatory tools and procedures

- The government has announced a review of APA (Administrative Procedure Act)
- A review of the administrative litigation system
- Introduction of Public Comment Procedure (1999) and No Action Letter system (2001)

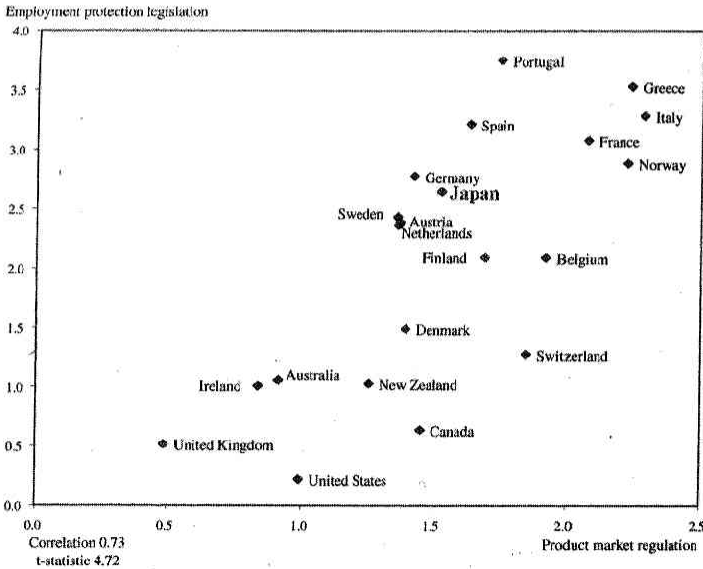
B. Position of Japan in the World Wide Regulatory Reform

Product market regulations—defined as regulations that have the potential to reduce competitions in all sectors of the economy—and Labor Market Regulation—defined as the strictness of employment protection legislation (EPL) for regular as well as temporary employment contracts—have been found to impose significant burdens on the domestic and international economy.

OECD's empirical studies show that countries with relatively restrictive and costly product market regulations tend to be associated with restrictive employment protection policies. Then, how far has Japan advanced in regulatory reform? G.Nicoletti's group developed the detailed indicators of regulation to estimate the degree of regulatory reform

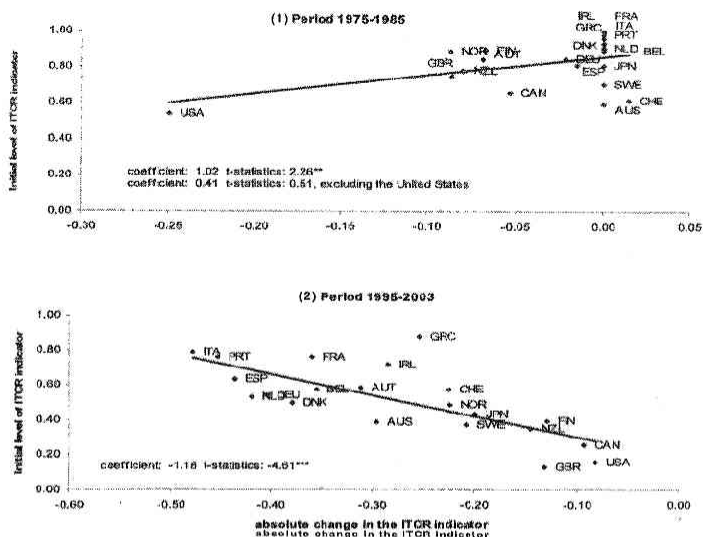
from an international perspective. They adopted the following steps for their quantitative analysis. (1) collection of the basic data and classification of the data into regulatory domains (e.g. state control, barriers to entrepreneurship, employment protection legislation), (2) definition of the detailed indicators, which constitute the basis for subsequent estimations, (3) estimation of the summary indicators for each regulatory domain and sub-domain, (4) estimation of the overall indicators for product market regulation and employment protection legislation, which provides the features of regulatory domains and the most synthetic measure of regulation. The completion of the first two steps include some subjective judgments, while the last two steps are relatively objective since multivariate analysis techniques are used to estimate the score of degree of regulation. According to their 1999 report, Japan had already taken the middle position in the OECD countries regarding both product market and labor market (Figure 2-1). This position should be evaluated, since the initial regulatory conditions in 1975-1985 had been far behind among them (Figure 2-2-1). But Japan was rated as the tenth most liberal country along with Sweden according to the OECD's measurement in 2003 (Figure 2-2-2).

Figure 2-1 Product Market Regulation and Employment Protection Legislation



source: ECO / wKP (99) 18

Figure 2-2 Progress of Product Market Reform- A Change from Initial Conditions



1. The ITCR indicator is measured as a simple average of regulation in 7 non-manufacturing sectors: Rail, road, airlines, gas, electricity, telecom and post. The indicators are normalised, ranging from 0 to 1, expressed as percent

Source: OECD International Regulation Database

As for Labor Market Regulation, Japan has promoted regulatory reform to enhance fluidity of labor market through alleviating a series of labor laws including the Dispatch related laws. Strict employment protection legislations seemed to have deprived the industries of opportunities to flexibly respond to the changing economic circumstances. The revised Dispatch law in 2004 and development of dispatch business appear to have contributed to it, while employment protection legislation for regular workers has not been reviewed substantially. This ambivalent measures has raised dualism in labor market, which has been criticized as inequality problems-household's income, regional gaps etc.-by the opposite political parties.

Regulatory reform in Japan has progressed to some extent, while it has raised new issues such as imbalance between deregulated industries and protected industries, income inequality and labor market dualism. In addition, important public utilities with networks as well as agriculture, healthcare and education still have remained not to be enough deregulated or open. Nevertheless, the long term efforts to promote regulatory reform have led to improving the fundamental index of micro-macro economy in Japan.

C. Results of Regulatory Reform- Consumer Welfare and Productivity

Some positive results are measurable and striking. The Economic and Social Research Institution (ESRI, Cabinet Office) tried to estimate the effects of implementing some of the major changes in terms of consumer surplus. The latest estimate in 2006, which confirmed the effects in mobile telephony, trucking, domestic airlines, car inspections, electric power, gas, oil, securities commission, insurance, beverages and foods, etc., is that these reforms as a whole increased consumer surplus by JPY 15.7 trillion, or JPY 131,000 per capita: this amounts to about 4% of GDP (Table 2-3). Consumer benefits induced by regulatory reforms are most striking in telecoms.

Table 2-3 Consumer Surplus between 1987-2000

unit: 100 million yen

	Sector	1987	1988	1989	1990	1991	1992	1993	1994
Telecommunications	Domestic Telecoms			983	3,274	2,884	2,123	2,439	2,214
	International Telecoms			694	653	341	137	13	86
Transportation	Domestic Aviation							495	468
	MOT Test System								
	Truck				-1,621	139	-965	-2,323	6,327
	Rail	771	728	958	902	1,305	1,523	1,366	1,520
	Taxi								
Energies	Electricity								
	Gas								
	Petroproduct								706
Finance	Stock Brokerage Fee								514
Food & Beverage	Rice								
	Alcohol						354	196	2,519
	Total	771	728	2,635	3,209	4,669	3,171	2,185	14,555

	Sector	1995	1996	1997	1998	1999	合計	2000	再合計
Telecommunications	Domestic Telecoms	916	5,747	7,817	7,143	2,486	38,027	4,644	42,671
	International Telecoms	149	213	118	569	388	3,363	261	3,624
Transportation	Domestic Aviation	301	440	952	431	301	3,387	201	3,589
	MOT Test System	2,450	1,728	866	552	377	5,974	352	6,326
	Truck	6,418	6,869	-363	3,119	3,215	20,816	2,832	23,648
	Rail	1,262	1,092	1,408	2,072	2,132	17,033	2,062	19,100
	Taxi			28	4	4	35	8	44
Energies	Electricity	1,918	7,424	1,262	5,928	0	16,532	3,018	19,550
	Gas	51	276	0	57	188	572	201	773
	Petroproduct	5,936	6,031	2,667	3,068	2,542	20,951	-1,952	18,999
Finance	Stock Brokerage Fee	95	512	-6	68	1,278	2,461	1,276	3,737
Food & Beverage	Rice	1,278	1,710	1,635	1,556	472	6,651	1,869	8,520
	Alcohol	1,103	1,387	-1,797	1,677	650	6,119	400	6,519
	Total	21,878	33,431	14,588	26,243	14,063	141,927	15,172	157,099

note 1. Figures in each year indicate the difference between the concerned year and previous year.

2. Blank cell means that regulatory reform was not implemented yet.

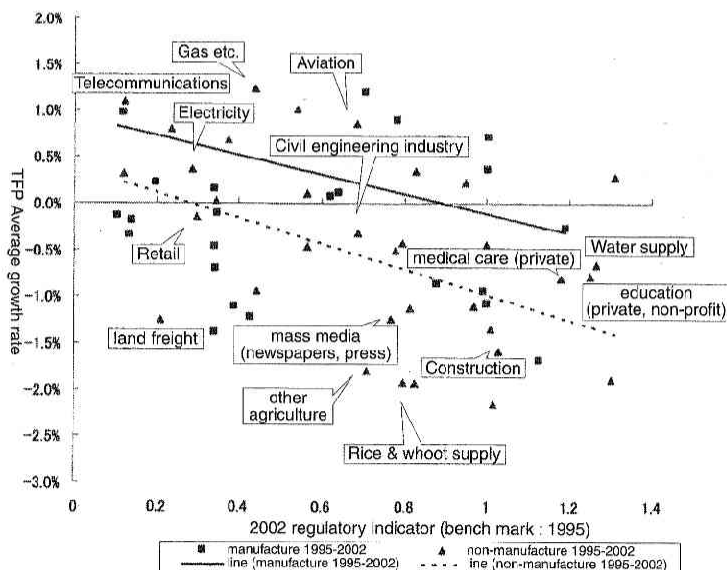
3. Figures of 2000 are expected values.

source: Cabinet Office (2003), Report on the Policy Impact Analysis

Another benefit resulting from regulatory reforms is the increase of TFP (total factor productivity) of the regulated industries. The ESRI also tried to estimate the impact of regulatory reforms on the changes of value-added share and the growth rate of TFP in each sector. It was summarized by the report on the assessment of structural reform in 2006. There, after setting the regulatory index (1→0), calculating the TFP (the estimation of Δ TFP by using Cobb-Douglas type production function and SNA classification in Japan) by sector dynamically, and doing multivariate statistics (principal component analysis) of the past growth of TFP, the report reached the following conclusions (Figure 2-3, Figure 2-4).

- Sectors, where regulatory reform has been advanced, have high productivities.
- If regulatory index decreases by 0.1 (standard year, 1995), the growth rate of TFP will increase by 0.14% (0.19% in the case of non-manufacturing).
- Regulatory reform has a large scope to bring in productivity gains in some sectors such as finance, insurance, real estate, construction, agriculture and electricity.

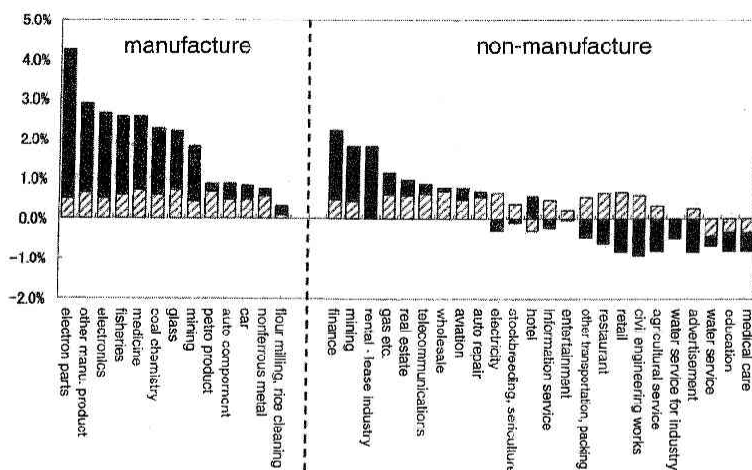
Figure 2-3 Interrelation between progress of regulatory reform and TFP growth rate (1995-2002)



Industrial sectors with zero index value are excluded here (as of 1995 or as of 2002).
Main types of industry are extracted from JIP2006.

source: Cabinet Office (2006), Report on the Assessment of Structural Reform 6.

Figure 2-4 The effect of Regulatory Reform on the change of TFP



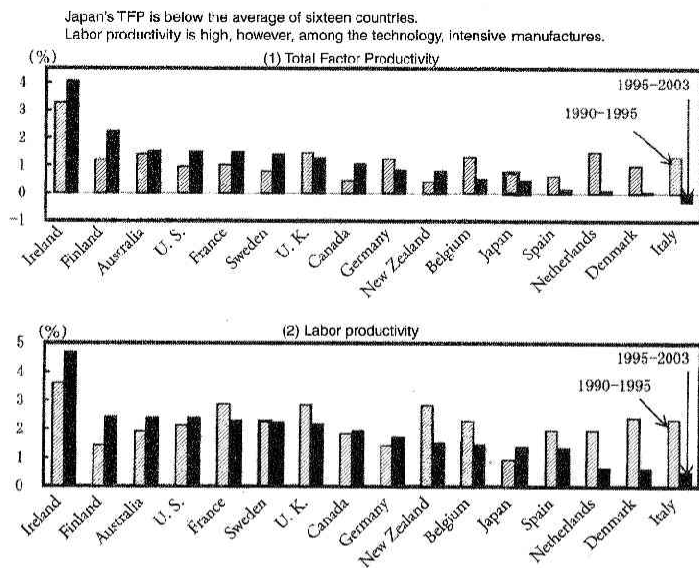
note: Part of oblique line means effect of regulatory reform on TFP growth.
The other part means other factors of TFP growth.

source: Cabinet Office (2006), Report on the Assessment of Structure Reform 6.

Japan should accelerate regulatory reform focused on the non-manufacturing sectors to further enhance the productivity and competitiveness.

In spite of the above results, actual average labor productivity still remains at the level of 84% of the U.S average in 2003 (Figure 2-5).

Figure 2-5 Growth rate of productivity in OECD countries



source: OECD (2006); Economic Surveys Japan

3. Conditions for Success of Regulatory Reform -Theory and Practice

A. Design of Regulatory Reform and Privatization

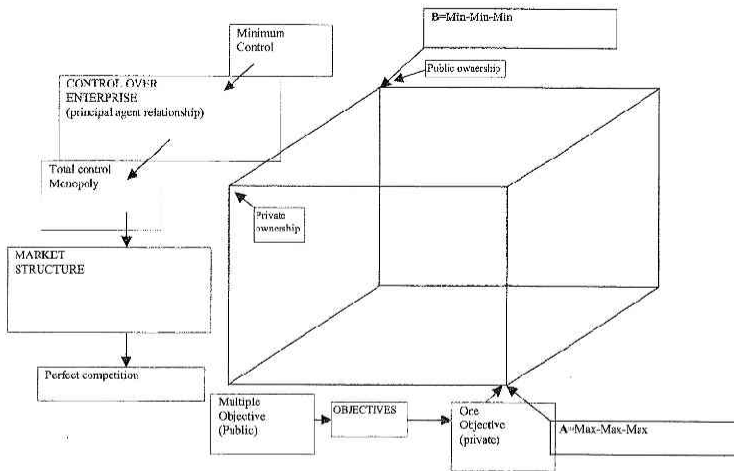
Regulatory reform and privatization policy have the same roots, the so-called market failures such as natural monopoly, negative externalities, public goods and asymmetry of information. To remedy them, the government intervenes in the market. Regulatory policy and public ownership (management) are regarded as two big methods of the state intervention. However, facing the change of economic and social environments, many advanced countries have been aware that governments themselves failed to remedy in these public policy areas. As a result, deregulation or privatization emerged as effective measures to overcome government failures. But, simple deregulation or privatization might lead to re-emergence of market failures and damage the public interests. This implies that the scheme of regulatory reform or privatization should be designed deliberately, taking account of some complementary measures. Among them, the most important measure is to create a competitive market, and to convert existing regulatory policies into new ones suitable for competition.

The government could implement such policy innovation by making use of various competition policies in accordance with market structure and market conduct. We have learned the following measures from experiences of reforms. (1) Duopoly policy (BT vs. Mercury, NTT vs. KDDI), (2) policy of oligopolistic competition (e.g. bank, insurance, and public utilities such as airlines), (3) policy of establishing a contestable market (sectors of natural monopoly), (4) structural separation (public transport, electricity, information-communication), (5) franchise bidding (local public utilities), (6) market testing (government services), (7) asymmetric regulation for natural monopoly and so on. To create competitive market has been a decisive and consistent factor of success

The importance of competition policy has been recognized in many economic literatures. For example, J. Vickers and G. Yarrow pointed out that the change of ownership works only on one factor of improving corporate performance, although it is likely to have significant effect upon market conduct. Its success depends upon the market structure (whether competition is effective or not) and regulatory policy (whether other substantive market failures are absent or not). They concluded that, "the main message, therefore, is simply that managerial incentive structures are determined via a complex set of interactions among factors that induce the type of ownership, the degree of product market competition, and the effectiveness of regulation". This view is also the case of regulatory reform.

From this viewpoint, the cube model proposed by A.E. Otto and K.B. Hartley is simple to understand the essence of privatization (Figure 3-1). According to their model, economic effects of privatization are influenced by the form of ownership (\rightarrow P-A relationship), market structure (\rightarrow competitive circumstance), and change of purposes of the concerned firm (\rightarrow public interest or profitability). They describe privatization as a movement of reform from a point B (min-min-min) to a point A (max-max-max). However, we can not expect the Pareto Optimality in the real business world. We should search the approximate equilibriums (second best) in the real market since deregulation is not carried out completely and the public-owned enterprise is not privatized thoroughly (Figure 3-2, Figure 3-3).

Figure 3-1 The Cube Model

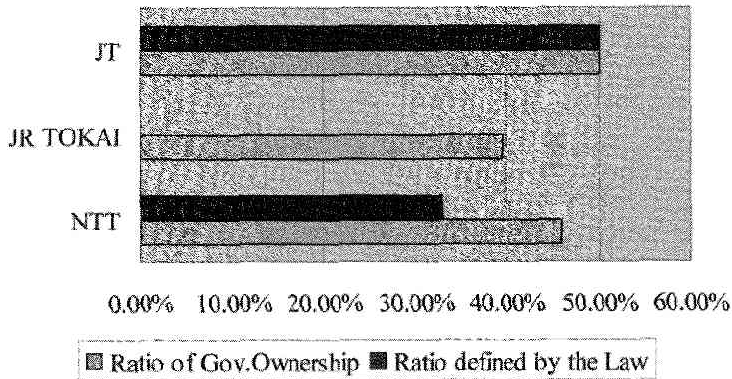


source: Attiat F. Ott and K. B. Hartley (1991)

In such circumstances, Government has several methods to achieve their policy goal. One method is to replace existing regulatory policies or tools with regulatory alternatives such as incentive regulation (price-cap regulation, yardstick regulation), which enables actual or fictitious competition in a monopolistic market. Especially, reform of interconnection charge (e.g. the so-called efficient component pricing rule or the long-run incremental cost rule based on the forward-looking cost) is very important to accelerate entry into the network industries. The other methods are to strengthen oligopolistic competition by fostering a competitive rival (duopoly) or to implement structural separation. The method which makes existing market with heavy sunk cost more contestable should be added to this basket.

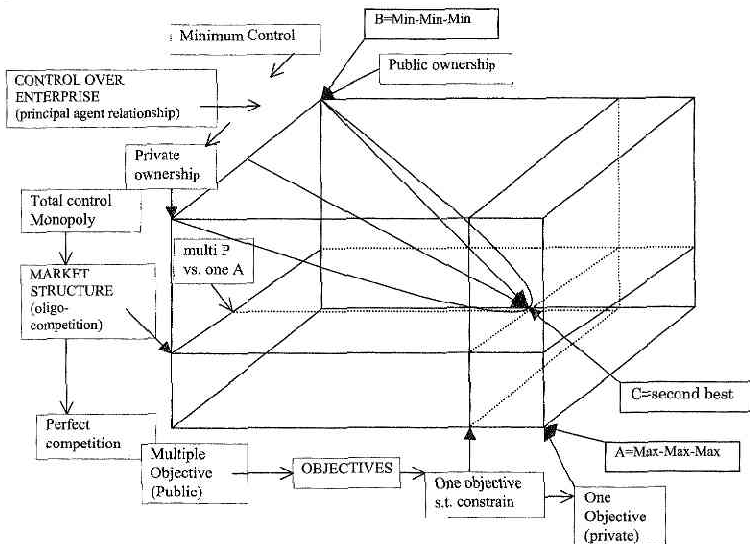
Figure 3-2 Share of State-Ownership

Gov. Ownership of NTT, JR, JT



source: Cabinet Office (2005), The Economic and Finance white Paper.

Figure 3-3 The Modified Cube Model



B. Japanese Experiences

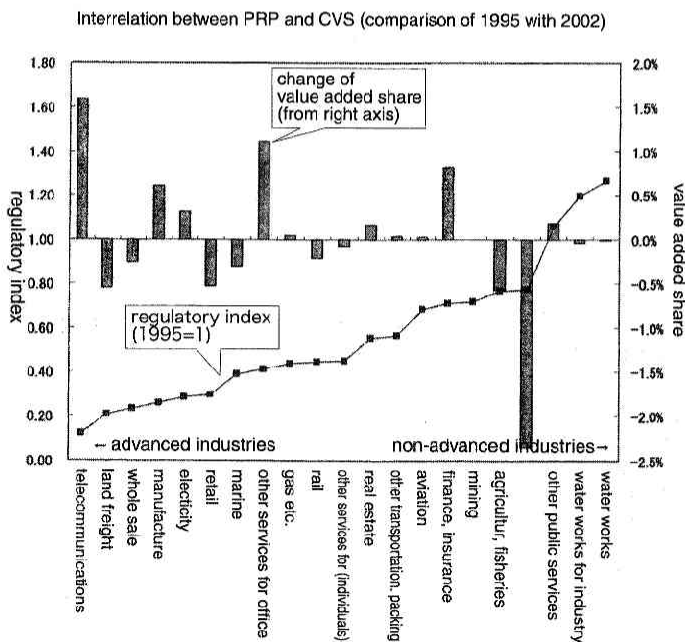
As for privatization policies, Japan privatized the three big public utilities in the

1980s. The results are as follows; the privatization of telecom (NTT) has been very successful. The privatization of rail (JR) has been also moderately successful, but the privatization of tobacco (JT) is not successful enough. This corresponds to the degree of progress of competition.

As for deregulations, they have resulted in positive outcomes. However, if we observe closely, some deregulated industries such as distribution, land freight, marine shipping, and rail have decreased the value added shares (Figure 3-4). These industries seem to hold some troubles to create sound competitive markets. As for distribution, the government stopped deregulation under the political agenda of re-vitalization of regional economies. The difficulties of introducing competition (JR group) and realization of excessive competition (land freight, taxi) should be regarded as the other reasons.

In summary, it is essential to decide an appropriate set of regulatory policy and competition policy in accordance with existing market structure in implementing structural reform. This is the core point of experiences in Japan.

Figure 3-4 Interrelationship between Progress of Regulatory Reform and Change of Value-added Share



source: Cabinet Office (2006), Report on the Assessment of Structural Reform 6.

C. The FTC's Experiences

The FTC (Fair Trade Commission) has enlarged its scope and strengthened its enforcement in parallel of structural reform. The FTC succeeded in promoting competition in the field of ADSL. The warning of the FTC that NTT should not refuse or delay the request of entrants accelerated competition around ADSL and gave an opportunity for the rivals such as Yahoo Japan and KDDI to compete the NTT group with new business models such as service of zero-equipment cost imposed on users. Due to this competition, the level of ADSL charge fell drastically in a short time and the users of ADSL increased rapidly.

On the other hand, in the case of airlines, the FTC did not secure effective competition sufficiently. In spite of the FTC's warning to the carriers, new entrants such as the Skyline and the Air-Do were suffered from the predatory price settings by the carriers. As a result, many users have not gained by tariff cutting in the airline sector. The FTC failed to control the merger plan between the JAL and the Japan Air System. Although the FTC allowed it by imposing some constraints, a change of market structure to the duopoly market of JAL and ANA, however, has not led to better performance of their firms and the increase of consumer benefits.

4. Importance of Competition Policy

A. Current Challenges of the FTC:

To overcome a conflict between restrictive regulation and competition, and to re-enforce the FTC's independence, the FTC was replaced as an "extra ministerial body" of the Cabinet Office in 2003. The FTC has traditionally concentrated its attention on the violations which caused the greatest economic harm, namely cartels and bid rigging. However, The FTC has tried to keep abreast of novel policy challenges.

The revised AMA (Anti-Monopoly Act) in 2005 has enabled the FTC to enlarge its coverage and strengthen the enforcement of competition law. As key policy issues, it included the review of the scope of exemptions from competition law, the review of non-competitive tendencies in regulation ("supply-demand" balancing provisions for controlling entry and exit) and the review of administrative guidance. The new revised law in 2006 gave the new powers to address official involvement in bid-rigging against administrative tolerance of collusion. Private suits are now authorized to seek orders and many suits have been attempted. Concerning the tools to enforce the law more effectively, the new law has raised the level of surcharges imposed on violations of the law, and

introduced a leniency programme, which is expected to bring competition enforcement more into line with the levels of deterrence in many other OECD countries. Related to this, the Whistleblower Protection Act came into force in 2006.

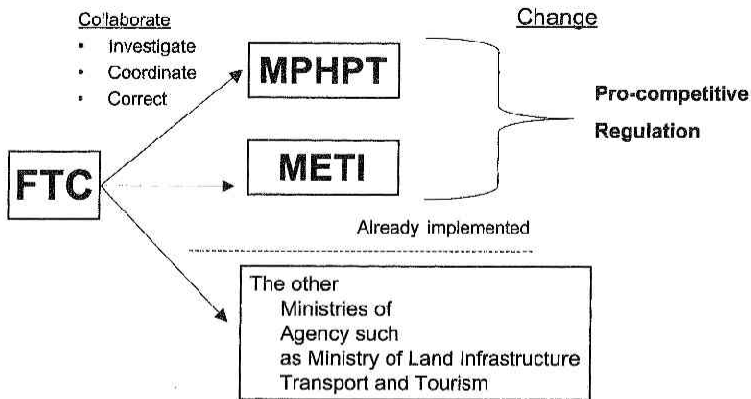
B. First Contact to Network Industries

The FTC has a power to interfere in the area of natural monopoly or “inherent monopoly”. This is very important because this area remains not to be exposed to the storm of deregulation in spite of the principles of “eliminating economic regulations and keeping social regulation to a minimum” and converting ex ante regulation to ex post control”. Another reason is that it is very difficult to introduce competition without the structural regulations, which the FTC has not adopted till now.

Repeal of the “inherent monopoly” exemption enabled the FTC to pay more attention to issues of network industries. The FTC’s Study Group on Government Regulations and Competition Policy researched network industries and required to eliminate distinction between carriers with and without physical facilities, to secure transparent interconnections and to allocate resources such as spectrum through bidding. In addition, this study group criticized the holding company structure of NTT group in terms of competition and urged that the holding company should reduce its holdings in mobile telephone service (NTT DoCoMo).

Actually, due to repeal of the “inherent monopoly” exemption, a part of power generation markets was liberalized with an auction system. This change expanded the potential application of the AMA in other network industry settings, too. Notably, the FTC examined the claims that the NTT group disturbed entrants about ADSL facilities, services and pricing practices. Here, the FTC has issued guideline jointly with the MPHPT which describes such conducts that would violate both the AMA and the Telecoms law. Similar guidelines about electric power and natural gas have been arranged between the FTC and the METI (Figure 4-1). However, co-ordination with regulatory authorities is still informal. The protocols requiring joint action, or arrangement on certifying about market power or abuse of dominant position are not defined explicitly.

Figure 4-1 Anti-competitive regulation



C. Current Challenges

Although restructuring or divestitures of monopoly firms is authorized by the special rule for a “monopolistic situation” (Sec.8-4), this has never been applied to regulate natural monopolies. If the FTC has a will to expand competition policy into network industries, the FTC should consider how to mandate divestiture under Sec.3. To make network industries more competitive, the FTC should prepare the powerful structural measures beyond the conduct controls.

As for “administrative guidance”, explicit interference in the market through administrative guidance appears to be declining, but change is difficult to identify. According to the 1994 Guideline, the relevant ministries should have sufficient prior consultation with the FTC to ensure that government regulations are not replaced by anti-competitive administrative guidance. However, the FTC does not report any significant case studies. The FTC is required to strengthen overseeing of tacit or hidden administrative guidance that is incompatible with competition.

The FTC should strengthen the criminal penalties. The threat of penalties does not yet deter violation of the law effectively, shown in the repeated rigging bids. In the 7 cases referred since 1990, over 60 individuals were prosecuted, but execution of all of their sentences was suspended. Ineffective deterrence invites repeated violations. In general, the capacity of the FTC to prosecute violations would be strengthened, if the AMA’s criminal penalties are to be applied credibly.

5. Interrelation between Regulatory Reform and Competition Policy

We have three big areas where “structural reform” overlaps competition policy. They are (a) reform of network industries, (b) outsourcing of public services and (c) regulatory reform accompanied by market openness.

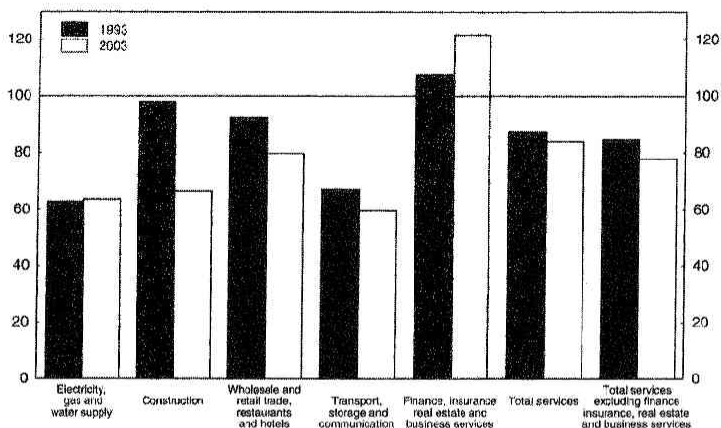
A. Network Industries

As a result of regulatory reform, many economic and social regulations have been deregulated. However, the public utilities, especially network industries except information telecommunication sector, have not experienced radical reforms and remains as inefficient natural or regional monopoly which has dominant position in their markets. Although OECD recommended that the regulatory framework for network industries should still be improved through structural unbundling, Japan has not adopted any action. The ministries insist that regulations have already worked sufficiently well. Consequently, the public utilities with network have been still inefficient and low-productive compared with those in the advanced countries (Figure 5-1). This is reflected by high prices of public utilities like the rates of electricity and gas.

OECD recommended that in order to dissolve recent labor productivity gap between Japan and the U.S. in the service sector (84% to the U.S. average in 2006), regulatory reform should be promoted further. However, to achieve better performance in non-manufacturing sectors, the FTC has to take an initiative for seeking necessary conditions for competition in cooperation with the controlling ministries. Implementing structure unbundling as well as strengthening the enforcement force into these sectors may be a promising method if the current approach by the jurisdictions does not work sufficiently (Figure 5-2).

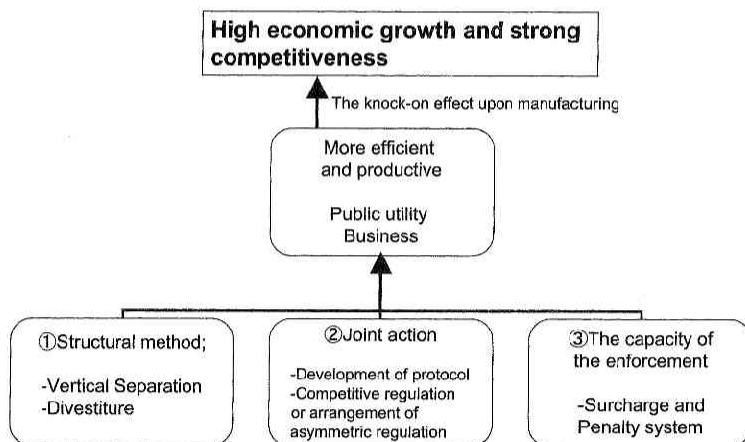
Figure 5-1 Comparison of Productivity in The Japanese Service Sector

US =100 using PPP exchange rate



Source: OECD STAN database and OECD Economic Outlook 79 database.

Figure 5-2 Challenges to Enhance Non-Manufacturing Regulation Including Regulation of Net-work Industries

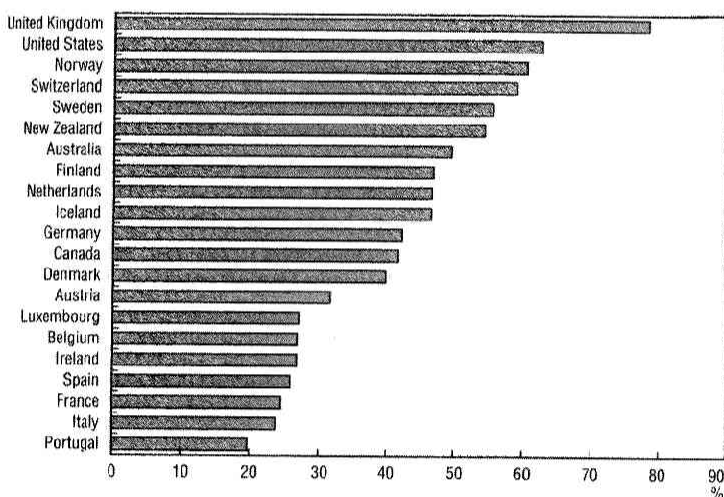


B. Front-line of Structural Reform

Regulatory Reform has been often promoted through the use of market-type mechanism. Alternative measures have been adopted to make public sector more effective or efficient. Market-type mechanism includes outsourcing (contracting-out), public-

private partnerships (PPPs) and vouchers. The other market-type mechanisms include market of transferable permits like emission trade market of greenhouse gas. The driving forces behind this phenomenon are the needs for the government to secure increased value for money in their operations and to ensure that public service should supplied more cost-effectively or customer oriented. Outsourcing is the practice whereby the government contracts with private providers for the provision of services to government, or directly to citizens on behalf of the government (Figure 5-3). This concept includes various terminology such as competitive tendering, contracting-out. This method has been applied to blue collar support service (building cleaning, catering), professional services (ICT), and core government functions (prison).

Figure 5-3 Outsourcing of Government Service



Source: OECD Secretariat calculations based on GFS Data.

PPPs refer to arrangement whereby the private sector finances, designs, builds, maintains, and operates infrastructure assets traditionally provided by the public sector. This bring a single private sector entity to undertake to provide public infrastructure assets for their whole life, generally 20-30 years. The private sector partner then charges an annual fee for the use of the infrastructure assets. This can be either paid by the government or through user charges, or combination of the two. PPPs are known as private finance initiatives (PFI). PPFs have been extensively used in the provision of transportation infrastructure, schools, hospitals, and sewage treatment facilities.

Vouchers separate the provision of public services from its financing. The funding remains with the government in the form of a voucher that is issued to individuals and which entitles them to exchange the vouchers for services at a range of suppliers. The voucher holders choose among different suppliers and pay with the voucher. Vouchers have been used for the provision of low-income housing assistance, primary and secondary education, and care services.

The use of these market-type mechanisms is expected to shape up the government. However, According to an OECD analysis of member countries' experience, there are some decisive factors associated with the successful use of market-type mechanisms. Observing carefully, we can find an essential common basis among them. The existence of competitive market is paramount-outsourcing. PFIs also require competitive biddings in their process (e.g. marketing test) and the voucher holders must be able to exercise a genuine choice of suppliers.

Market-type mechanisms have been applied to a wide range of government functions. On the other hand, a number of governance-related issues (staff issues associated with outsourcing, risk accompanied with the transfer of management etc.) have occurred. However, these reforms will be inevitable because the efficiency gains which can be either in the form of decreased costs, improved service quality levels or improved allocative efficiency are substantial. On this point, competition policy support establishing better environments in these reforms.

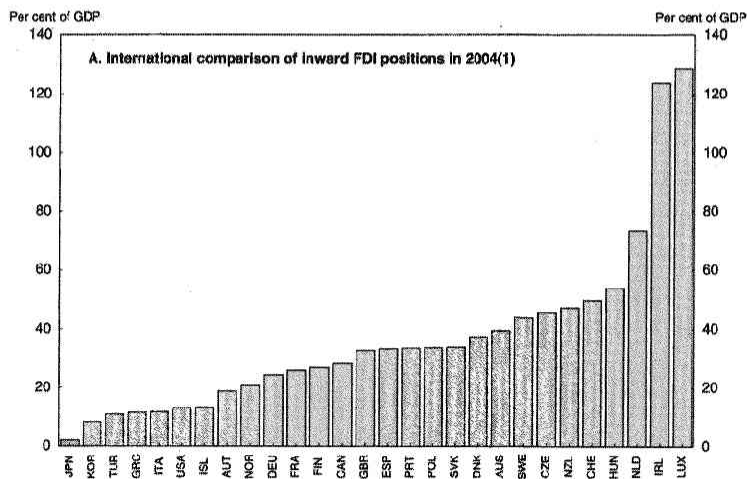
C. M&A and Competition Policy

The Council on Economic and Fiscal Policy (CEFP) announced "Japan Globalization Strategy" in 2006. The report aims at enhancing Japan's international competitiveness. This report includes a range of proposals to obtain such benefits:

- Improve and expand human resources; Establishing an environment that attracts outstanding talent from other countries, Improving the immigration system, etc..
- Strengthen international competitiveness; Raising efficiency in agriculture, implementing the third basic plan for science and technology, Doubling the stock of inward foreign direct investment to 5% of GDP by 2010, etc..
- Strengthen the global competitiveness of regions in Japan; Increasing the number of foreign tourists to Japan to 10 million by 2010, etc..
- Foreign policy and contribution to international society; Creating an East Asian Economic Zone, Accelerating negotiation of Economic Partnership Agreement, Reforming Overseas Development Assistance, etc..

Among them, the inward FDI problem is very important so as to maintain Japan's highly competitive position as a front-runner in global economy. The FDI becomes an increasing driver of global integration as multinational companies to implement global strategies. During the second half of the 1990s, the worldwide total of FDI tripled, led by a rise of cross-border M&As. Japan participated in this trend with its stock of inward FDI more than tripling from 3 trillion yen to 9.4 trillion yen between 1998 and 2002. Consequently, Japan's share of world FDI increased from 0.5% in 1998 to 1.2% in 2004. However, the impact of foreign affiliates in Japan has been limited by their number and size. Despite the increase, the stock of FDI in Japan as a share of GDP remains the lowest level in the OECD area at 3% (Figure 5-4). The Japan Investment Council (JIC) established the "Programme for the Promotion of the inward FDI in Japan" in 2003 and has tried to increase FDI till now. Although this programme includes improvement of the environmental for cross-border M&As as a key item, M&As have not proceeded as much as expected. Between 2002 and 2004, the sale of EU companies to foreign firms accounted for almost half of the total of cross-border M&As in value term, while the sale of US firms accounted for another one-fifth. In contrast, the Japanese share was only 2.3% (Table 5-1).

Figure 5-4 International Comparison of Inward Foreign Direct Investment Positions



Source: European Investment Bank(2004) *The EIB's role in public-private partnership*, July

Table 5-1 Cross Border Mergers and Acquisition

	2002		2003		2004	
	Billions of US\$	Per cent	Billions of US\$	Per cent	Billions of US\$	Per cent
A. World total by seller:						
United States	73.2	19.8	69.7	22.8	61.9	21.5
European Union	208.8	56.5	126.0	42.4	178.8	47.0
Japan	5.7	1.5	11.0	3.7	8.9	2.3
Other OECD ¹	27.7	7.5	20.9	7.0	39.1	10.3
Rest of world	54.4	14.7	68.4	23.4	71.9	18.9
Total	369.8	100.0	297.0	100.0	380.6	100.0

1. Australia, Canada and New Zealand.

2. Based on public announcements.

Source: UNCTAD (2005) and Koo and Yang (2006).

Japan's low share reflects some special factors. One reason is that Japan's M&A market is originally small because of the unique business practice and corporate culture which constitute a Japanese-style management. Japanese firms often take the negative attitude for the inward M&As, regarding them as "vulture funds". The second factor is the discriminate treatment of foreign firms in M&As. Non-cash transaction (exchange of shares) was not allowed in the case of foreign firms, even though such financing method accounted for 70% of M&As within domestic firms in 2002. The third factor is that Japanese companies still have the practice of cross-share holding in accordance with their group or Keiretsu, which is believed to make a barrier to the outside attackers.

But last May, foreign companies was allowed to have the same rights as domestic firms in using non-cash transaction for M&As. This is called "triangular mergers". If foreign companies established their subsidiaries in Japan, they can use their parent company's stocks to acquire a Japanese company. Allowing foreign firms to use non-cash transaction may significantly facilitate the inward FDI.

If so, a more transparent, merger guidelines or rules will be required. The 2003 FTC's merger guideline has become gradually clear that match for the global standards in terms of safe harbor or HHI index. However, the process of pre-notification consultation about mergers has not been sufficiently clarified. Merger control relies on prior consultation and negotiation. It is said that the parties want to avoid the risk that the FTC will block their plans after they take the formal statutory procedure. To avoid opaque procedure, the FTC should adopt the kind of 2-phase investigation process which is popular in the EU. Another problem is related to the enforcement of merger control. The enforcement force relies on the discretion of competition authorities. Although the FTC have succeeded in cracking down on hard-core cartel and tendering collusion, in the field of M&As the FTC have not necessarily succeeded enough.

Conclusion

Regulatory Reform necessarily requires commitment of competition authorities in order to achieve the expected results. However, to promote competition in the public sector is not so easy because the real public sector has many complicated factors which do not adjust to market mechanism. Even if the regulated industries were liberalized, their markets might be away from competitive markets. There is a risk that market failure might re-emerge and impede a function of market mechanism. Therefore, in promoting regulatory reform, competition authorities should come to the front.

In turn, the successful competition policy can contribute to better regulation. If competition policy does not work well, regulatory reforms, even though they have fine menu and schemes, would go into a stall. In contrast, if competition policy works well, through improving economic performance, regulatory reforms would be accelerated further. In summary, regulatory reform should be complemented by competition policy and competition policy should be strengthened in parallel with regulatory reform. Both are correlated closely.

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